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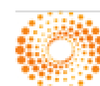

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PRESENTATION

John Dawson *- Rolls-Royce Holdings plc - Director of Investor Relations*

Good morning everybody, and welcome to Rolls-Royce's first-half results for 2016. My name is John Dawson, I'm the Director of Investor Relations at Rolls-Royce. With me here today are Warren East, our Chief Executive; and David Smith, our CFO.

Our agenda today is as follows: Warren will kick off with some highlights of the first half. David will then run through the financials in more detail, before Warren then returns to take you through some comments on our transformation agenda and priorities for the second half of the year.

The presentation should last around 35 minutes, and we'll have plenty of time for questions afterwards. We are conscious you need to be away by about 10 o'clock to go on to your next meeting, so we'll try and make sure that finishes on time.

Before I hand you over to Warren, let me just remind you of our few housekeeping matters. We are presenting the presentation today as a webcast, as well. We will be able to take questions for those of you joining us on the webcast; Please submit your questions online and we will make sure they are asked in the room, if they haven't been asked already, or followed up with afterwards, if we do not have time.

Please turn off your mobile devices, out of courtesy to the speakers.

And finally, we will be including forward-looking statement in our presentation. Please refer to the slide in your pack about that.

Our numbers will be on a constant currency basis, unless stated. That includes our comments on guidance.

With that, I'll hand you over to Warren.

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Warren East ***- Rolls-Royce Holdings plc - Chief Executive***

Thank you very much, John. Good morning everybody and thank you for coming. We do understand that it's a very busy day for results today, and you've come along to share some of that time with us, so that's very much appreciated. Thank you.

Now, those of you who can remember, this is roughly where I left off in February when talking about our full-year results for 2015. And we're going to stick with the same framework for talking about our results this morning.

The framework here is the priorities that I set for 2016. I'm going to start off now and, after talking a little bit about the business, talk about restructuring. I'll pick up with the other priorities when I come back after David has run us through some numbers.

For the Group as a whole, the first half of 2016 has been a steady start. Actually, the business is a little bit better than we expected for profit and cash in terms of the absolute numbers as of the end of June. That is largely due to timing of certain deliveries in our Civil Aerospace large engine business, and a little bit in Defence Aerospace as well.

We are saying this morning that our expectations for the full year remain absolutely as they were, which means we have still got a lot to do in the second half. However, we remain confident in those expectations for the full year.

It's driven by the schedule of production and deliveries in our Civil Aerospace business; the timing of a few specific Defence contracts; and also, fortunately, the benefit of some of the restructuring activities and simplification activities that we're starting to do, some of those benefits are starting to come through. That’s all pretty much in line with what I said at the beginning of May, at our AGM.

So now we'll just have a quick look at the business, some of the highlights from the first half of the year. I'll start off with our activities in Civil Aerospace.

Looking at new engine programs, these are engines which are not in service at the moment and which are going to be fueling our growth in future, we hit some important milestones. Here's a picture of our new version of the Trent 1000 TEN engine. At Farnborough, a couple of weeks ago, we were able to announce that it had received EASA certification.

Also in the new engine sphere, our Trent XWB-97, this is the higher-power version of our Trent XWB engine, has also been achieving its first flights on our flying test bed, and things are going well there.

The big lever for our civil aerospace business, however, is achieving the ramp up in volumes that we need to achieve last year, this year, next year, and so on. In 2015, as a reminder, we supplied just over 300 large engines in total. The Trent XWB production was just starting and a small part of that.

This year we expect to deliver 400 large civil engines. We're on track for that, having delivered 164 in the first half. And incidentally, that included just over 100 in the second quarter.

We're moving the volume run rates from around about 30 per month to around about 40 per month. That's happening, as we speak. We anticipate the next couple of quarters significantly over 100 engines per quarter, and that will take us in to the realm of just over 400 engines for the full year.

I'll talk a bit more later, about manufacturing lead times and what we've been achieving on improvements in manufacturing lead times. This is, of course, one of the drivers that's enabling us to ramp up the volume like this.

As I look forward at the Civil Aerospace business over a slightly longer term, on the graph here you can see the slightly longer-term view. We understand this is a business which grows in the long run.

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There are short-term perturbations, caused by external events. But when you look back on those in history, they don't make a huge amount of difference to the long-run picture.

And we also get small perturbations when we have things like spikes in orders. And that leads to, in the moment, a little bit more capacity in the market than there is demand, and you get perturbations there.

As I sit back and look at the slightly longer term, however, I see a strong order book, which continued to grow in the first half of the year. I see us increasing our capacity to service that strong order book. And I see firm commitments from our airline customers and our airframe partners. And that is putting resilience into our revenue growth for the future.

Near term, we absolutely hear about higher shipments of widebody airplanes, a little bit of softness in passenger kilometers. That does certainly put out more risk there in terms of risk of deferrals, risk of slowing things down.

But interestingly, we're not actually seeing any changes from the airlines, particularly in the routes that they're flying, which is what really drives our engine flying hours So, from an aftermarket point of view, we are comfortable at the moment.

From an OE point of view, if some of these risks start to materialize then what we can see at the moment, at most, is a little bit of re-phasing actually helping us with some of our delivery plans, and easing a little bit of that pressure. That's what we're seeing versus anything radical. Obviously, if we see some radical changes we'll be up and we'll be talking about it, we'll let you know if we see that change.

Right now, if I wanted to talk about a concern, the concern is simply in terms of our resource; the significant demands that we are currently placing on our engineering teams as they seek to help with this ramp up of volume, at the same time as bringing some very sophisticated new engines in to production. However, things are going pretty well on that front, at the moment.

So, let's move on to Defence Aerospace. That was a steady first half, and a very good set up for the full year. Looking forward, there are opportunities for new OE over the next five years to 10 years. And we are working we're keeping our designers, we keeping our designs fresh, and working with the partners on those for as and when the opportunities materialize.

But this business, for the time being, is mostly about what happens in the aftermarket, servicing the fleet that's out there, and getting that servicing activity more efficient and more profitable, from our point of view.

We're doing things like working more closely with our Defence customers, getting some of our activities physically located on the site with some of those customers, so that we can get more value out of our aftermarket business, and share that value with those customers, and actually, give them better service as well. We're investing in future technology to build on this strong position, both for the aftermarket and OE.

We have a strong position today in transport and patrol. And we have opportunities in combat. And our investments are all targeted at that.

Looking around the rest of the business, I'll start with Power Systems. Like in 2015, the first half of the year was fairly close to breakeven. It reflects lower volumes and product mix, where we've certainly seen higher shipments of the lower-margin products.

Meanwhile, our R&D focus is on higher volume applications, like power gen, where we can leverage capacity and grow our market share, and really capitalize on the high performance differentiation that our products have. And so, we're comfortable with where we are with that business for the second half of the year.

Switching to Marine, it has been a very difficult period, and it's been a difficult period for quite a long time now. We're seeing some good results from the restructuring that we've been doing in Marine. We've been focusing on R&D; we've

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actually increased -- it's not hard to increase to increase the R&D as a proportion of the revenue in the Marine business -- but we have actually stuck with the expenditure of R&D, investing in new technology there. I'm quite encouraged by the innovation that's happening in the product portfolio.

We announced an investment in some new permanent magnet technology, to expand that activity, a few weeks ago. Meanwhile, as the offshore sector in oil and gas continues to be depressed, we're seeing people get a little bit more creative in terms of seeking opportunities in slightly different applications in fishing and other non-oil and gas applications. It's really stimulating innovation in our marine part of the business.

In Nuclear, we are investing. We've announced some headcount increases. This is to service better the business that we do with the UK Government on submarines and we've made progress there in terms of improving our project management, our manufacturing and deliveries. We're also exploring opportunities with small modular reactors.

Switching now to one of those key priorities, I'll talk about this transformation one now, before handing over to David.

Back in February, I talked about the need to address what I called the organizational hardware, that is the structures and organization; and the software, the activities, what people actually do. We have been proceeding with the left-hand side of the chart, hence the green tick, where we've been looking at the structure of the business, simplifying the structure of the business. That's where the initial focus has been.

We're seeing costs leaving the business, I'll come up with some numbers in a moment, and we're certainly on track, at the top end of expectations there.

Moving forward, in the second half of the year, the emphasis is switching to the right-hand side of the chart, where we attack some of the way we work, the way we share information, and the way management decisions get made within the business. That is certainly harder, and it's a bit less tangible as well, so it's also harder to talk about it. But I'll endeavor to talk about that a bit more, later in the year.

On the tangible side, we're very much on track to deliver the GBP150 million to GBP200 million that we talked about in terms of cost reduction for the end of 2017, and going forwards that's what showed in the cumulative savings here. By the time we finish with 2017, we're absolutely in the zone for GBP150 million to GBP200 million out.

The initial phase we've done, so we're actually talking about achieving very close to GBP50 million for 2016, which is at the top end of expectations. And those changes will also have a knock-on effect, and we'll actually benefit from an additional GBP50 million as we move in to 2017.

For the next steps, for the remainder, it's work in progress. We've identified activities that we can reduce, which we hope will deliver GBP20 million to GBP40 million of benefit in 2017.We have some work to do to find some more in 2017, and moving into the piece which comes from the end of 2017. But I'm comfortable with where we are at the moment; it's work in progress, a little bit more to do. But six months in, we're in pretty good shape.

Just a reminder on how some of that plays out, what we've tried to do here is show diagrammatically the simplification at the top of the organization, where we've effectively moved from nine businesses to five, and we've connected those five much more closely at the top of the business. That has really sharpened the ability for us to make decisions. It has increased accountability and raised the level of debate at the Executive team.

We are starting to see some real simplification here in how we execute the business. And that simplification is, for instance, measured in terms of reduced number of committees that we have to operate the business: reduced frequency and reduced numbers of people that are there at those meetings.

It's very much the start of the simplification piece. There is no shortage of opportunity here to reduce the complexity. The business is engaging well. As far I'm concerned, I'm very encouraged by the response that we're getting around the business. I stress, it's a good start, but it's only a start.

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So, overall, pretty good first six months. There's still a lot to do. I'll talk about the other priorities shortly, meanwhile, I'll hand over to David.

David Smith ***- Rolls-Royce Holdings plc - CFO***

Thank you very much, Warren. And good morning to everyone. It's really good to see you here.

Warren has already run through some of the operational highlights. I want to stress, obviously, the results were clearly down, as expected, versus last year, but we did end up marginally ahead of pre-close expectations. The business clearly responded to the rallying call there.

This outperformance was principally down to Civil Aerospace, and included some earlier than planned deliveries, and a profit on some spare engines, together with more life-cycle cost reduction, and a little bit of an FX tailwind.

We also had particularly strong end-of-period cash flows, which are always hard to predict, and included some early delivery of second-half actions. But again, evidence, I think, of the business responding to the challenges that we'd given them.

In addition, Marine, while still negative, had a good end to the period. Both of these parts of the business have more to do with the second-half phasing. And any real upswing in performance or outlook is something that we're still cautious around.

We believe that Group underlying performance remains broadly in line with the expectations that we gave you earlier in the year, on a constant currency basis.

As I go through this presentation, any percentage change, in fact, on sterling value I give will be at constant FX rates, and on an underlying basis.

Moving on to dividends there's no change from what we said at our full-year results. We're halving the interim dividend from its 2015 level and so that will pay out at 4.6p. That implies just over GBP300 million total cash outflow to shareholder payments in calendar year 2016.

And talking about our balance sheet, also, S&P did adjust their ratings in May and now they're in line with Moody's and Fitch at A minus. But we still do have a very robust balance sheet with good liquidity that's been helped during the year by the additional GBP500 million of revolving credit facility we raised in April, that's now up to GBP2 billion.

We continue to pursue a prudent financial policy. While we do have some cash calls, such as the ITP purchase consideration, coming up over the next 24 months or so, these are definitely manageable.

Turning now to Group revenue, at a Group level our OE revenue fell by 5%. That was due, fairly equally, to Civil Aerospace headwinds and much larger offshore market declines that we've talked about in Marine.

Likewise, our services revenue was 5% lower, for broadly similar reasons that we've explained before.

In fact, throughout these slides you can see that the first half outcome really does reflect the headwinds we identified during last year, and reconfirmed at the full-year results presentation in February.

We have seen some positive impacts of translational FX, on a revenue basis, that added GBP183 million. I'll talk more about this in a moment.

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Turning now to Group profit, the headwinds we've discussed really did lower gross margins, you can see that fairly dramatically on this slide, and were the core factors in the decline in Group profit before tax.

In other parts of the income statement, the differences were relatively small, and mainly related to non-recurrence or repeated costs and benefits from last year. That included GBP39 million non-repeat of underlying restructuring costs, as the aerospace program is now largely implemented.

I'll just add that the transformation program and the Indianapolis redevelopment program have been booked in the first half as exceptional costs. we can come back to that.

Similarly, the non-repeat of a GBP24 million finance benefit that we saw last year on dividend hedging in 2015 contributed to financing costs being up about GBP35 million versus last year.

We're also in line at the moment with our remuneration targets for the year. At this point, we are accruing bonus in line with that policy, that does impact C&A, which is why you see an increase in C&A. Part of that comes through in the gross margin, as well.

So here is our usual bridge from profit to cash flow. On an absolute basis, the main drivers were a GBP235 million increase in net working capital. That included a GBP149 million increase in the TotalCare net debtor to GBP2.36 billion together with inventory build-up in preparation for the rise in second-half production.

We did see some offset, just FX related, and favorable effects of translation of net foreign receivables and payables.

We had just over GBP300 million of CapEx spend during the quarter, part of which was actually payments for 2015 invoices.

And of the GBP232 million increase in intangibles you can see here, GBP90 million came from CARs. The net movement after amortization was GBP71 million, taking the balance in the period to GBP460 million at period end. The rest of the intangibles movement primarily related to higher R&D capitalization.

Cash flow was clearly better than we'd expected at this point in the year, primarily because of the work on working capital. It was certainly helped by earlier customer receipts; some earlier delivery, for instance, of those spare engines; and also, some forecast OE concession payments which slipped in to the second half and a pull ahead there for some of our second-half cash actions.

Thinking about the year over year, which isn't actually on the chart, profit was clearly down. CapEx spend was only up marginally and the net long-term creditor balance increased by about GBP176 million year over year. We did see, as I said, a strong favorable move in net working capital.

Before I turn to the divisional review, I should probably talk a little bit more on foreign exchange.

At year end, we have $29 billion of dollar cover, and the average hedge book rate was about $1.59. As I say, that hedges our dollar exposure, which is currently about USD5 billion to USD6 billion. It will increase over time as we see volumes increase. This absolute exposure will increase over time as volumes increase.

We have been taking, since the beginning of the year, both before and after the Brexit vote, advantage of the weaker pound in terms of adding to that hedge position; and we've now, at the end of June, increased that $29 billion up to $35 billion. That's still well within our normal tramlines.

And so, over the next five years or six years, that equivalent cover, that's about five years or six years equivalent cover. It's spread over a longer period than that, because we hedge progressively and the most recent transactions were clearly being struck at much better forward rates in the $1.35 to $1.40 sort of range.

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And that has brought our average hedge rate down. The average hedge rate in the hedge book at the end of the quarter ended up at $1.57, as opposed to $1.59 at the end of last year.

All our hedges, as I said, are taken in line with the policy of trying to lower volatility and smoothing our margin over time, so there won't be any FX cliff in the forward rates. And we'll continue to take on longer-dated cover as we use existing deals.

In practice, this means we're only likely to see a gradual decline in the long-term effective rate in any one year. Therefore, I would suggest that, for those of you who are modeling our long-term rates in the outer years, I would be cautious about prescribing too much value to these short-term spot movements that we're seeing. Of course, we all know that those could come back at some stage, in any case.

So there are a lot of movements going on through foreign exchange, caused by sterling weakness. It's worth running through maybe a couple of other areas where that impacts on the business, particularly around transactional impacts.

On translation, there's more detail in the Data Appenidx as the recent significant changes made this much more pronounced.

On revenue now, we'd expect, roughly, a GBP600 million translational impact for the year if current spot rates continue at the point they were on June 30; and the profit effect would be about GBP60 million, as opposed to, I think, the GBP40 million we were talking about previously.

We've also adjusted our long-term planning rate. This is the rate at which we both do our long-term decision making, but it also goes into the long-term contract accounting. That is reflected, therefore, primarily in Civil Aerospace, and we'll continue to review that. That added, as it says here, about GBP35 million to civil profit. It also changed the order book by about GBP2.1 billion in terms of the valuation of the order book.

And then finally, the big number is the non-cash mark-to-market movement just on the hedge book itself, which does hit our reported profits by nearly GBP2.2 billion on our derivative contracts. This has very little real impact on us. We don't get concerned by this figure, and nor should you, as it will be fully offset as those contracts mature in the underlying transactions which are being hedged.

So, in conclusion, while we're clearly a net beneficiary of the recent FX movements, our conservative long-term hedging strategy and translational exposures make our in-year benefits relatively modest.

Right, turning now to the divisional commentary, we've provided the same breakdowns as last year in the statement. In the interests of time, given it's such a busy day, we've cut back some of the charts today, but you do have them in the Data Appendices. I'm just going to focus on the key points for each division.

Starting with Civil Aerospace, both the revenue streams were down around 5%. For OE, this was principally due to lower linked Trent 700 sales, and to lower corporate sales of the BR710 engine.

On aftermarket, we did see a significant increase in our in-production Trent fleet, recorded, roughly, a 15% increase in installed base and flying hours. But this was more than offset by the reduced activity, particularly on time and materials that we've talked about before on the Trent 500, the Trent 800 and also the RB211 and regional jets.

Turning to the revenue mix itself, linked engine revenues were up 3%. And that was helped by high deliveries of the Trent 900 and the Trent 1000 as well, offset by that lower Trent 700 delivery picture. Trent XWB deliveries also helped drive the improvement in unlinked sales. We saw lower business aviation, as I already referred to.

V2500 module volumes were lower; and that reflects the declining volumes ahead of the airframe transitions away from Rolls-Royce engines.

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If we turn now to the aftermarket revenue, declines in the large engines were driven, as I've just said, by lower activity in the legacy fleets, particularly on time and materials. This was mitigated by a 4% growth in thrust, and the 15% engine flying hours growth from the in-production Trent fleet that I've described.

While business aviation aftermarket activity was pretty stable in the period, the regional aftermarket continued its downward trajectory, and, as an offset, we saw higher V2500 aftermarket revenues.

Turning to gross margin, starting with the volume and trading margin bars, the significant proportion really came from the Trent 700 headwinds that we talked about last year. These were around GBP130 million negative impact, along with aftermarket headwinds from the legacy fleets. This is very consistent, as I've said, with the guidance we gave you last year.

Turning to long-term contract accounting adjustments, you can read a fuller description of this on page 12 of the statement. In absolute terms, the net of all of this was actually relatively small; it produced a net GBP23 million reduction, compared to a GBP48 million positive last year, so a GBP71 million year-over-year effect.

And within that, there are five specific catchup elements. 66% (sic - see slide 30, "GBP66 million") of the year over year was due to a gain that we had last year on the risk policy adjustments that we talked about. And that was, if you remember, GBP189 million in the full year, but GBP66 million in the first half.

We also saw a GBP64 million negative effect from higher technical costs, that was various in-service-related programs, particularly around the Trent 1000 and the Trent 700.
We saw lifecycle cost reductions of GBP35 million, which was a GBP10 million improvement from what we'd seen in the prior year. And then, as I'd mentioned earlier, there was a GBP35 million impact from the change in our long-term planning rates for foreign exchange. And then, GBP14 million, basically, of all other, which are primarily a whole series of operational and commercial factors.

Turning, therefore, to the full picture, beyond that large movement in gross margin there were fairly limited movements. The increase in C&A was more than explained by the incentives accruals that I've described.

Lower R&D was lower due to increased capitalization for the Trent 1000 TEN engine.

We saw lower underlying restructuring charges. As I said, the management reorganization has been booked as exceptional.

So, the end result was a profit of GBP31 million. That's down 91% from the prior year, GBP22 million, or GBP31 million after FX.

The overall profit was higher than we had expected for the first half, which had been forecast for a modest loss. However, this was largely due to the timing effects that I described right at the beginning.

In the second half we're going to continue to face some of these legacy headwinds, but we would expect a stronger performance overall, in line with expectations, with headwinds mitigated through increased deliveries, including profitable spare engines and positive results from our dedicated focus on improving lifecycle costs in the in-service fleet.

Turning now to Defence. Defence revenues were marginally lower with strength in OE revenues offset by some weakness in spare parts, principally, again, for legacy products. This product mix did have a negative effect on gross margin.

And, in addition, we booked a GBP31 million charge, which is for both incremental expenditure and expected expenditure, around the whole improvement program on the A400M; this is our efforts to try and help the consortium in getting over some of the technical problems that we've obviously seen on the gearbox and other areas.

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Restructuring costs were lower as the focus is now switched to the upgrading of the Indianapolis site, which we're treating as exceptional.

So net defense profits, at GBP123 million, although they were down GBP61 million from last year, about one-half of that was due to the TP400 charge that we took.

Looking forward in to the second half, we expect performance will be supported by growing engine deliveries, particularly of the AE2100. While we have some headwinds from supporting the TP400, as I've said, we're trying to mitigate that in terms of a full-year effect.

Turning to Power Systems, Power Systems had a solid start to the year. We did see slower oil and gas sales, and also a little bit on the rail and the naval side, that impacted OE revenues; and particularly aftermarket in terms of the service side of oil and gas. But segments such as construction, agriculture and power generation were actually considered stronger than a year ago.

As I said, service revenues were affected by lower activities, particularly in the energy and commodity sectors.

The adverse mix of all these movements, on top of the smallish decline in revenue, did mean that we saw lower gross margin, but that was partly offset by slightly lower spend on R&D. Therefore, the profit impact of all of that was relatively modest: a GBP6 million decline to GBP11 million profit.

In terms of resilience, we won't be immune, clearly, to the challenging market dynamics. That's very evident, I think, from peers. But our revenue base certainly has strength in the high-speed markets, which helps us here. So whilst some short-cycle sectors are hard to gauge at the moment, the order book coverage is over 80% in some of the longer-cycle parts of the business, and particularly in higher margin sectors.

So this is broadly consistent with the prior year, we have a cautious but positive outlook for the full year for Power Systems. But, undoubtedly, there's much to do in the second half on both revenue and cost.

I think Marine, given the market environment, had a pretty creditable first half, and was a little better, or perhaps less bad, than we had expected. But order weakness was there, including cancelations, were particularly a feature of the offshore market.

OE revenues reflected pretty low volumes, while services were a little more resilient, but still at subdued levels. This isn't really surprising as services do tend to lag the OE market a little bit by nine to 12 months.

In contrast, naval and merchant segments actually held up pretty well; we did OK on order intake on naval, as well.

The team has worked pretty hard to try and find opportunities in adjacent markets to offset some of the direct offshore side.

And within gross margin, the significant impact was really from volume, rather than any decline in trading margin. There was also no recurrence of the GBP30 million contract provision, if you remember, that we took last year.

I think overall, Marine's loss of GBP14 million, which was down GBP18 million, from a small profit last year, was a pretty good result. While our original guidance may now seem a little over-pessimistic as the businesses continue to work hard on rationalization efforts, it does, I think, still reflect caution in the marketplace. There is still risk of further cancelations, and I think it is right to continue to be a bit prudent here.

Finally, for Nuclear, we did see the Nuclear businesses actually improve in revenue terms in the first half. That was led primarily by strong growth in OE activity in the submarines business, which mainly reflected program-phasing.

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We had some delivery challenges to overcome, and these did depress our margins a bit. The submarines business is very, very focused on achieving cost-effective, on-time deliveries at the moment for their core customer.

Overall, Nuclear profit of GBP17 million was marginally down on last year.

On the civil nuclear side, we are seeing quite a lot of good business opportunities at the moment, particularly around instrumentation and controls in China and other markets. So the long-term outlook for our Nuclear business actually remains pretty positive.

We've also, as has been described in the press a bit, started to make some modest investment in development work around small modular reactors. That clearly depends on government decisions. But we think we're very well positioned there, and want to continue to support what could be a very interesting market opportunity for us.

Covering our technical factors, our guidance, basically, remains the same. We do expect higher net R&D spend to be closer to GBP900 million now as we support a very full program of delivery milestones, as Warren described, on the new projects.

I'm just going to finish on some comments around the impending arrival of IFRS 15. I say impending, although the implementation is still two years off.

It does feel appropriate to introduce this topic at this point, given its likely significant to reported results. And I wanted to give you my best view as to the framework which we're likely to apply now in Rolls-Royce, coming from our own initial and tentative conclusions from some very detailed work we've been doing.

We are trying to seek consistency across the Aerospace sector on this, although there may well be some detailed differences in interpretation, I think we're getting quite close to that. Overall recognition is now going to be linked much more to the actual timing of provision of goods and services, rather than smoothed over the lifetime of service contracts.

The one clear and firm constant that I want to really emphasize is it doesn't change the cash flow profile. Therefore, the embedded value of the business, and you'll hear this again and again, really isn't impacted by this change.

Our initial conclusion as to principles of what's likely to change is that we will no longer apply the contractual aftermarkets rights, or CARs concept. We will no longer essentially capitalize engine losses.

We also wouldn't differentiate in future between linked and unlinked contracts. As you know, that's partly happening anyway, because of changes in market mix, but we would actually move away from that treatment.

And for both OE and aftermarket, the timing of revenue recognition and offsetting concessions would change to an input basis, in other words, cost, with consequences that will have some different profit and loss effects.

As a result, all of the OE revenues, net of concessions, will be recognized at the time of sale. And, therefore, we'd no longer see the pull ahead of profit from some of the linked accounting that we've seen in the past, ahead of cash flow.

TotalCare would be recognized over the contract term with higher margins, therefore, because we're taking the concessions upfront.

Catch-up adjustments and contingencies are also likely to be smaller, while the impact on time and material is probably largely unchanged, although we still have to work through that.

I thought it would be helpful to give some overview of the impacts on the balance sheet and the profit and loss. This really is the high level. This is the very detailed set of changes that we're going to need to make here.

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At the outset, we'll have some balance sheet transition adjustments as we will essentially move to a completely new set of accounting policies, and the CARs and TotalCare net debtor balances are, therefore, going to be eliminated, or at least significantly reduced.

Going forward we're likely to see a greater focus on the TotalCare creditor line. Unfortunately, we're not going to get a complete alignment, even with this, between profits and cash, but we'll get a much closer alignment.

A number of consequences are within the profit and loss account. First, the changes to OE profit recognition mean that the full cost of any engine build will be taken in the first year. This underlines the importance of our focus on improving our unit cost position for cash purposes, which will significantly reduce these cash losses over time.

Secondly, the removal of the CARs balance. Since we're no longer going to be capitalizing the losses, we won't have any amortization charge either.

The most complex area that we're working through, to be able to give a more coherent aggregated view of the results, is the removal of linked accounting and the changing of revenue recognition points. This will affect timing and margins, and will be quite contract specific. We'll come back to you with a likely time for an IFRS teach-in, which I envisage to be during Q4, when we're able to do that.

But in the meanwhile, I hope we've given you some help, some leadership really, in helping you understand these principles, and actually, how they're probably going to apply to the whole industry.

And finally, I'd just like to reiterate once more, that this does not affect cash.

So, just to sum up, let me summarize our Half One performance.

Overall, this was in line or ahead of expectations for the first half; but as a whole, it's stronger, but we don't think that this is going to come through in terms of a full-year effect.

So while the phasing in Civil and Marine brought forward a little of the Half 2 performance, we've made good progress in mitigating market weaknesses, there's still a lot to do in the second half.

We are making good progress on cost. We've put in a strong cash performance. Clearly, FX is now a bit of a tailwind, although we also have some technical issues, like the TP400 to offset.

And finally, I think we've got a reasonable order position. The focus now is clearly on the second half, and our ability to execute on our orders and our strategy in order to deliver full-year expectations.

So, thank you very much. And now, back to Warren.

Warren East ***- Rolls-Royce Holdings plc - Chief Executive***

Thanks, David. I'll try to be fairly brief. You can see a number of slides in the pack, but I promise I'll try and go fairly swiftly over this next few.

I hope you appreciated the communication there about IFRS 15, and our desire to get ahead and start engaging and talking about that, and, I suppose, that's really speaking to the box on the far right-hand of side of the slide here.

I'm not going to talk any more about the box on the far right-hand of the slide, that's really for you to judge. I'm going to talk a little bit about what we're doing on priority one, focusing on our three key areas.

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These three key areas are essentially what we do, engineering excellence; how we do it, operational excellence; and how we deploy that in our business through our business model. The biggest lever we have there is using our installed base of engines.

There are many examples of actions in all of these three areas that we could take. The way these slides build up, you can imagine, in each one of these themes, in each one of these boxes there are some actions. They accumulate, and they accumulate in terms of benefits to the business. What I'm going to do is just pick on a few examples in each of these areas.

So, let's look at engineering excellence, to start with. Our engineering excellence is the collective of the experience, knowledge, skills, techniques and know-how that's been built up in Rolls-Royce over well over 50 years. Deploying that is potentially hugely beneficial for our business.

But deploying that sort of stuff which has been built up over quite a long period of time is quite challenging, because a lot of it is just locked up in people's heads, and, in particular, quite a lot of it has historically been locked up, if not in people's heads, on pieces of paper.

So here's an example where we are digitizing some of that, some of our product definition, so that that knowledge can be transferred. It can be transferred around different parts of the globe where we're carrying out different activities. It can be carried between different teams to get more efficient and effective re-use of that knowledge.

Now, we think when we complete this project then we will be able to reduce the time it takes to develop a new product by about 20%. We'll have completed that project, it's going to take several years, by around about 2020.

As you can imagine, my first question on this was how can we do it a bit sooner? And I will continue to push on that. And our creative collective brains at Rolls-Royce will work on how we can realize this benefit a little sooner.

But that's an example of one of things that we're doing.

Now, switching to the operational excellence, I mentioned at the start of the presentation one of the tools that we have at our disposal to be able to deliver on this ramp up of volume, doubling of volume run rate of our large civil engines, is to reduce the amount of time it actually takes us to make one of them.

As we have put Trent XWB engines in to Derby, so we've moved some of our Trent 1000 production to Singapore. And over a period of several months we've worked -- we've had lean workshops with everybody brainstorming on how they can reduce cycle time and make that operation more efficient.

After about four months, so far, we have taken about 25%, a little bit under 25%, away from the lead time that it takes us to assemble a Trent 1000 in Singapore.

The good news is that we think we can take this quite a bit further, an additional 15% to 20% coming out on that particular engine. And we think we can then take some of those techniques and apply them back on Trent XWB and possibly make a very significant lead time reduction on how long it takes us to build a Trent XWB.

If that materializes then that's making a huge impact on the available capacity. And you can see why that's quite a powerful tool in enabling us to deal with the volume ramp that we have to deal with.

There are opportunities in other parts of the business as well. And I'm not going to go in to all of these examples, in the interests of time. But applying the same sort of methodology in other parts of our business, this is the sort of improvement in lead time out there we're seeing in some of the activity in our Power Systems business.

Moving on, away from the engineering and operational excellence and thinking about how we effectively utilise the assets that we have out there, which is our installed base. One of the issues which people have been talking about increasingly

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over the last 12 months has been the maturing of the fleet of engines that we have out there, airplanes being parked, and so on.

Now, it is a normal thing that airplanes start off with one owner and after some period of years they move on to another owner, so the second-hand market develops. Now, typically, people keep their airplanes for eight to 12 years, and so after about eight years this starts to become a phenomenon.

We have a relatively young fleet of Trent engines. We've got an older fleet of RB211s that are coming to the end of their lives, but our new Trent engines are relatively young. And you can see that in 2010 we only had about 200 of these that were eight years, or older. Today, we've got about 500 that are eight years or older; and in 2020, we will have about 900 that are eight years or older.

And once you get in to that eight years or older phase then there's a propensity to start thinking about transitioning from new to second hand, they become second hand and transition to a new owner. That can take about six months just for the aircraft to be refitted, and so, six months out of flying, this is a potential downward pressure on our aftermarket revenue.

So if we can do something about smoothing that transition that's a good thing for our aftermarket revenue. And it's going to become increasing important, as we look forward.

We have introduced a dedicated team to work with financiers, to work with leasing companies, to work with our airline customers. And the good news is that since introducing this team at the beginning of this year then we've become much more effective at transitioning airplanes from one owner to another, compared with the corresponding period last year.

Again, on leveraging the installed base, a few weeks ago at Farnborough we announced a partnership with Microsoft. This is where we are working to take our product knowledge, customers' knowledge, industry knowledge, combine that with data from our engine health monitoring, do some analysis, use some analysis tools, predictive tools, and improve the customers' operation, release some value so that we can release some value for our customers and, potentially, share some of that value in our service business.

We've deliberately chosen not to invent all our own here, but work with technology partners, like Microsoft, so that we have an open architecture for our digital activity.

At Farnborough we announced that partnership, and we're looking forward to applying that around the industry in Civil Aerospace. We are looking at applying it to other fleet operators, in sectors like Marine, and combining some of that with some of our smart-ship innovation that we're doing.

Before we close, it's important just to put ITP in context. And I think the context is largely about leveraging our installed base. We have been working with them as a risk and revenue sharing partner for many years, we moved a little bit closer last year, and, especially, as we look forward to Trent XWB and Trent 1000 volume ramps, they become more significant as a partner.

Our joint venture partner chose to exercise a put option, absolutely the timing was their choice not ours. But directionally, this is quite a desirable thing as we can consolidate more of the high value that is there in both the OE and aftermarket.

Now, as I look at all the Trent engines that ITP have been working with us on, and particularly looking to, Trent 1000 and XWB, we can see an increase of more than 10% in the value that we will now consolidate in aftermarket revenues coming in.

So, a quick reminder before I close. We do have some legacy issues. We're making good progress, I think, at embedding behavioral changes into the organization, and best practice in this sort of thing. We've got no significant announcements to make in terms of any enquiries, but just to remind you that that is still out there.

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Our second-half priorities are to deliver on what we say we're going to deliver; maintain some progress on the transformation that I talked about earlier and hopefully continue with a more open dialog with the outside world. Back at the ranch, we'll be concentrating on those three strategic priorities to drive value.

With that, we'll move on to questions and answers. Well, questions, and we'll try to answer. Thank you.

QUESTION AND ANSWER

Christian Laughlin ***- Bernstein - Analyst***

Christian Laughlin, Bernstein. Two questions from me, please. First one, particularly for Warren, in regards to your ongoing review, what have you learned over the last six months, incrementally? And how have these insights influenced what your vision is shaping up to be for the future of the Company? That's the first one.

And then secondly, around the production ramp, in particular, with XWB over the next five years, how confident do you feel about the bottom part of the supply chain?

And what I mean around forgings and castings, where, in particular, Rolls-Royce, as well as GE and Pratt & Whitney, are relying on some of the same suppliers to support respective production ramps over the next few years. How's your confidence level about that part of the supply chain being able to keep up?

Warren East ***- Rolls-Royce Holdings plc - Chief Executive***

On your first question, I'm afraid, we could go on all morning. But, basically, I've continued to learn, and I'm encouraged by the amount of opportunity there is for simplifying and taking activity out.

Some of those numbers that we've put up there on the slide, they're almost anecdotes, but actually some of them are the result of a lot of hard work for a lot of people over a period of time. But they are fantastic improvements.

If we are able to realise that lead time transfer, which we've proven on Trent 1000, and transfer that to the Trent XWB that's equivalent to almost doubling our capacity, with no incremental operational costs since it's just materials. I've been hugely encouraged by that over the last six months.

I suppose it has been more of a quantification of the opportunity that I felt that was there in the first place. As I say, we could go on all morning, there's lots of that.

In terms of the supply chain, then we are talking about a significant increase in volume for us, and for the industry as a whole. But compared with the other activities that some of these companies do, it's not actually that significant an increase in volume.

We work closely with these companies. There are always challenges in terms of actual deliveries. But we have teams embedded in these suppliers that work with them on a day-to-day basis and solve the problems, as and when they arise. I'm not pretending that there are no issues, but I'm comfortable with the way in which we interact with those suppliers at an engineering level.

Christian Laughlin ***- Bernstein - Analyst***

Thank you.

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Ben Fidler ***- Deutsche Bank - Analyst***

Ben Fidler, Deutsche. A couple of questions, please. Are you able to share with us how many spare engines you delivered in the first half, and what that was the year over year? You mentioned that that was quite a significant driver of the growth. That would be helpful.

Secondly, I see you've increased the TotalCare net debtor guidance by about GBP100 million to GBP200 million over the next 12 months. Does that mean we should be thinking that civil profits will be GBP100 million to GBP200 million higher than we were previously expecting over the next 12 months?

And the third question, on the accounting stuff -- thank you very much for the early heads up on that, I think it's been a fascinating part of the release this morning.

The profit effect, my head's not big enough to understand that for some time but just sticking with the easier part, which is the revenue effect, are you able to give us any indication of how much could civil aero see a revenue impact from both the OE, as you no longer have that future pull forward, and secondly, on the shop visits, which you won't be booking? Or the revenues you won't be booking until shop visit, with a lot of the fleet still being relatively young, as you demonstrated in your slide 49. Presumably, anything less than five years on that chart isn't going to actually be going through the revenue line under IFRS 15 on shop visits. Just any sort of steer on that would be very helpful, at least to understand some revenue-scaling effects in civil? Thank you.

David Smith ***- Rolls-Royce Holdings plc - CFO***

Why don't I try that in reverse order, while I try and find the spare engine number?

In terms of IFRS 15, I don't want to get in to numbers. It is complex, Ben, and I think we're all going to be challenged by this. The combination of the fact that we have some engines already clearly in service, like the Trent 700, the effects will be different from new engines, like the Trent XWB, means that we have to go back and look at this actually on a contract-by-contract basis and work our way all the way through that, including the RRSPs, and all that sort of thing.

Your main point, that there's got to be a timing difference, I completely agree with. That's one of things that we need to understand better in terms of new projects, in particular, the later booking of revenues. I'm not able to quantify that at the moment; that is what we're working through.

In terms of the TotalCare effect, part of this is what we've already actually seen, which is the long-term planning rate did have an effect, so that does come through the TotalCare net debtor. We also expect some higher overall impact on lifetime cost improvements in the second half; and that's offsetting, within civil, other issues that we have, particularly, on the engineering spend that you've seen increase.

So, yes, there is going to be a change in the mix of civil profit, but not a net improvement when we take all that in to account. And that's why we've adjusted the TotalCare range a little bit, because, as you've obviously figured, some of those effects come through in the TotalCare net debtor.

Helen, can you help me; I know it's in here

Helen Harman ***- Rolls-Royce Holdings plc – Investor Relations***

We sold a few in the first half; not significant in volume terms

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Warren East ***- Rolls-Royce Holdings plc - Chief Executive***

It was more a reflection of XWB is a new engine, airlines are taking this engine for the first time, we need to put more spare engines around so that we can satisfy that.

David Smith ***- Rolls-Royce Holdings plc - CFO***

Yes. We will see more in the second half. So the second-half effect is quite a bit bigger, because in the first half I think we sold three XWB spare engines, something like that; we're going to see a lot more than that in the second half.

John Dawson ***- Rolls-Royce Holdings plc - Head of IR***

We have a question from the webcast, if I may, from David Perry. It's a question for Warren. There have been recurring press reports that Rolls-Royce could achieve significantly higher cost savings than the formal plan currently in place. Could you comment on these reports, please?

Warren East ***- Rolls-Royce Holdings plc - Chief Executive***

Yes, obviously, I've seen those reports, and talked about them with journalists. This is a performance gap between ourselves and the people seen as the market leaders.

First point, the number one difference between our Civil Aerospace profitability and that of our number one competitor is driven by the difference in maturity of our fleets.

We have a young fleet. The proportion of aftermarket which is relatively profitable compared with OE, which is relatively less profitable, is skewed, in our case, more to the OE than it is in the case of our number one competitor. So when you put the two pieces together, they are going to be significantly more profitable than we are. So some of it is a business model maturity factor.

The rest of it is, indeed, a performance gap, and that's a performance gap that I see no reason why we can't close, and that's what our transformation program is about.

In terms of quantifying it, we've quantified the savings that we expect to be able to make for the end of 2017. We're reporting this morning that we are very pleased with the progress over six months, at the top end of our expectations in terms of that trajectory. As and when we communicate, we'll probably end up doing an IFRS teach-in, and we probably need to do an update towards the back-end of this year as to how we're doing on the transformational program, maybe we'll talk about rolling the targets a little bit further out.

But, for now, I'd like to concentrate on actually delivering what we've said we're going to deliver. As and when we can talk about fresh targets, we will. I don't think the performance gap is an unreasonable performance gap to think about closing.

Gordon Hunting ***- Fiske - Analyst***

Gordon Hunting, Fiske. On something quite specific, on the TP400, why isn’t the blame put to GE Avio; why do you have to pay?

Secondly, Pratt & Whitney has also got a problem on planetary gear boxes, whereas you have fantastic expertise on the J35 and the F-35B. Why can't you profitably help those other two manufacturers to sort out their problems?

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Warren East ***- Rolls-Royce Holdings plc - Chief Executive***

On the specific of the TP400, it's not a question of us paying for any inadequacies caused by other people; it's a question of us, as part of a consortium, helping our customer to solve a problem.

For instance, one of the things that our team has done over the last several months is vastly reduced the cycle time to take one of these engines and service it, mainly by removing the need to take the engine off the wing and creating some apparatus which enables us to service it on the wing. That has reduced the cycle time from about three weeks to about two days.

And that's great as far the customer is concerned; it's great as far as we're concerned, as well. But it does cost. It's the cost of developing some of that stuff that we've booked today; we have not taken the cost of somebody else's problem.

Sandy Morris ***- Jefferies - Analyst***

A very mundane question; when did we last change our planning rate?

David Smith ***- Rolls-Royce Holdings plc - CFO***

It was actually about a decade ago. And we review it every year; I felt, given our actual experience on rates over the last 20 years, I couldn't justify leaving it at where it was, and that was something we discussed with our auditors as well. So I think that was the right decision to make.

Sandy Morris ***- Jefferies - Analyst***

If I remember correctly, the last adjustment probably came when the hedge book was at about 183, or something?

David Smith ***- Rolls-Royce Holdings plc - CFO***

Sorry, I wasn't around. I can't remember, Sandy. But when we looked at the data, it was fairly clear that we needed to make a change. We are not necessarily even responding to the short-term spot movements; it was much more just the progression of what we've seen over the last few years.

Sandy Morris ***- Jefferies - Analyst***

Thank you. And then I know we're in a hurry, but I'm fascinated with this Trent 1000 thing. But while I'm fascinated by the technical costs that go on and on, things happen, I'm really fascinated by this Singapore thing. I can understand how you get a lead time change in Singapore, because we kind of, I thought, made our life more difficult by putting it in Singapore. For that to be able to bring XWB down 50%, it would be astonishing.

Warren East ***- Rolls-Royce Holdings plc - Chief Executive***

As I said in terms of how I presented this, if we map across what the changes that we've made to the processes and procedures then that's what we can achieve.

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It's unproven at the moment, because we haven't mapped them across, and it's also a bit of a round number. I think what is definitely in there, however, is that the improvement is very significant, or the potential improvement is very significant.

Sandy Morris *- Jefferies - Analyst*

It's just fascinating. And then, without going into numbers in IFRS 15, but TotalCare, I can't imagine it's going to change things where we make or assemble; I don't believe these people can work to TotalCare. But in terms of our commercial approach, is that going to change, do you think, the business for the better in terms of focus on cash, or focus on profit, or whatever? Thank you.

David Smith *- Rolls-Royce Holdings plc - CFO*

I think it completely underlines the focus on cash that we've been trying to actually change over the last couple of years in the business anyway.

I made the point that the way to mitigate the CARs effect is to get the cash losses out as quickly as we possibly can, but equally, managing the whole cash cycle is going to be very important here.

I think it will help internally, because it's removing some of the barriers in terms of just understanding the numbers. I think it will help externally, because of getting a closer alignment of profit and cash over time. But absolutely, running the business and trying to improve cash conversion is a clear imperative, whether we have the accounting change or not, to be quite honest, but that gives added impetus to it.

Warren East *- Rolls-Royce Holdings plc - Chief Executive*

So, we've got one from the webcast, I think.

John Dawson *- Rolls-Royce Holdings plc - Head of IR*

We'll take one more question from the webcast in the time we've got available. Apologies, we do need to finish at 10, to give you a chance to get onto other meetings.

This is a question from Chris Hallam. On the new accounting basis, will you still disclose all the various elements that you are currently intending to disclose around engine flying hour payments, and engine losses etc. that you set out back in February?

David Smith *- Rolls-Royce Holdings plc - CFO*

Well, I certainly don't see us moving away from the enhanced disclosure. It may be as we look at the standard further there's some other things we want to disclose as well.

Clearly, one of the things that we will all have to think about is how to model the shop visits. I think it's a bit early to get in to that yet, but there will be implications like that, we need to think about, yes.

Warren East *- Rolls-Royce Holdings plc - Chief Executive*

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We've got another -- I think we've probably got time for another couple from around the floor.

Harry Breach *- Raymond James - Analyst*

Harry Breach, Raymond James. Three quick ones. Firstly, can you help us think a little bit about where we are with the parked Trent 800 situation; in terms of how many of those moved during the first half, and broadly, where the parked fleet is at?

Secondly, just looking at Civil Aerospace, now I'm very slow on the uptake at the best of times, but aftermarket change at constant FX, negative 5% in the first half. And I think, David, you called out T&M down on the 500, 800, RB211- and RJs. Given that T&M, I think, last time I recall seeing a comp, was about 27% of overall aftermarket at civil. And presumably, the TCA side grew in line with flying hours on the Trent fleet. Does that imply T&M was down really quite hard, like 20%, year on year?

David Smith *- Rolls-Royce Holdings plc - CFO*

T&M was down a lot, I think. In roughly revenue terms, it was around GBP100 million, something like that.

Harry Breach *- Raymond James - Analyst*

The final one was just about Marine. I appreciate the oil price has moved up a little bit, it's not long since it bottomed out. Just wondering if you're seeing any early signs of behavioral changes from your offshore customers. Any signs of bottoming out?

Warren East *- Rolls-Royce Holdings plc - Chief Executive*

Okay, I'll answer that one, and then go back to the Trent 800.

The answer on Marine is that it does appear that we are moving along the bottom, rather than getting worse. I think the change in behavior is that we're not seeing further declines. But if you think about it from a service point of view, people have still got plenty of spare boats out there to go and remove components from to service the ones that they actually want to use.

On the Trent 800, then we are making good progress. I think I put on the slide the effectiveness of the team there in terms of getting airplanes back in to service.

And I believe the numbers that we're talking about, around about 13 airplanes have been placed in the first half; and we have a further 28 where owners have been identified. And that's a big improvement compared with where we were one year ago.

Harry Breach *- Raymond James - Analyst*

What percentage of the Trent fleet is stored?

David Smith *- Rolls-Royce Holdings plc - CFO*

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Overall, it's a bit shy of 10%, I believe.

Rami Myerson ***- Investec - Analyst***

Rami Myerson, Investec. Just two questions. On working capital, there's been a lot of discussion in the last few weeks about a deterioration in terms of payment to suppliers. I'm just curious if some of the improvement in working capital was due to delayed payments to some of your suppliers, and if you are planning on changing terms.

David Smith ***- Rolls-Royce Holdings plc - CFO***

No, there was an effect, there were some FX effects, as, I think, I mentioned on payables, but not from terms.

We've –going to, or we may have done already, I can't remember exactly the timing, issue a new policy. We are absolutely coming on board with the new version of the voluntary code that the government has encouraged, particularly around earlier payments to smaller suppliers.

John Dawson ***- Rolls-Royce Holdings plc - Head of IR***

With that, I'm afraid, we have reached 10 o'clock. We're going to call a halt to the general Q&A there, so those who want to rush off can rush off. We'll probably do one or two questions in the margin as we're leaving. Thank you very much, everybody.

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